“Ray Kroc – Cultural Impact of McDonald’s”

Quest Club

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Ray Kroc – Cultural Impact of McDonald's

My assigned topic – Ray Kroc – Cultural Impact of McDonald's – was a curious assignment for a trial lawyer. As I commenced my research, I wondered if my fellow Quester who assigned the topic wanted me to focus on Ray Kroc's development of McDonald's and the cultural impact his restaurant empire had on the business community, real estate industry, franchise systems or, more broadly, the cultural and social impact of the fast food empire on our American way of life and the health and well being of our citizens. I assume it is all of that and more. Rather ambitious for a 30-minute Quest Club paper!

Let's begin with a word association test:

QSC – Quality, Service, Cleanliness

Ronald McDonald House

McDonald's All-American Band – Macy's Day Parade

McDonald's High School All-American Basketball

Big Mac

Egg McMuffin

Billions and Billions Sold

McNuggets

Super Size it!

"Cheeseburger, Cheeseburger!"

Hot Coffee – The Verdict

Golden Arches

McJob!

All of those phrases and images are a tribute to the marketing power and genius of Ray Kroc and the McDonald's restaurant empire.

Let's first define the meaning of culture. In modern anthropology, the development of a culture is viewed as a process. W.C. McGrew lists six steps in the process:

1. A new pattern of behavior is invented, or an existing one is modified.

2. The innovator transmits this pattern to another.

3. The form of the pattern is consistent within and across performers, perhaps even in terms of recognizable, stylistic features.

4. The one who acquires the pattern retains the ability to perform it long after having acquired it.

5. The pattern spreads across social units in a population. These social units may be families, clans, troops or bands.

6. The pattern endures across generations.

McGrew's anthropological definition of culture applies to modern business corporations and particularly franchises. It also aptly summarizes the development of McDonald's as a business and cultural icon. All of this, of course, is credited to Ray Kroc. In fact, Ray Kroc was the salesman, organizer and visionary, but it is the McDonald's franchise business method which leads to the McDonald's iconic culture.

I. <u>RAY KROC – SALESMAN AND ENTREPRENEUR</u>

Ray Kroc was born to parents of Czech origin in Oak Park, Illinois, October 5, 1902. During the first World War, he lied about his age and became a Red Cross ambulance driver at age 15. Kroc in his autobiography, "Grinding it Out – The Making of McDonald's," writes, "In my company, which assembled in Connecticut for training, was another fellow who lied about his age to get in. He was regarded as a strange duck, because whenever we had time off and went out on the town to chase girls, he stayed in camp drawing pictures." The strange duck was Walt Disney! Author John Love in "McDonald's: Behind the Arches," writes about the two famous underage ambulance drivers. "Curiously, the two would develop remarkably similar business empires – both dedicated to perfection in their operations and the youthful spirit in their marketing. Though each admired the other, they were character opposites. "Kroc was open and outgoing; Disney was so much the reverse that the men in his ambulance company voted him least likely to succeed." "He was always drawing pictures while the rest of us were chasing girls," Kroc would recall a half a century later. "Therein lies a lesson, because his drawings have gone on forever – and most of those girls are dead now."

After World War I, Kroc returned to high school but then soon dropped out. He mixed professional piano playing with working as a salesman for the Lily Cup Company in 1922. He sold paper cups by day and played piano for a local radio station at night. In the mid-1920's, he drove to Florida and pedaled real estate during the Great Florida Land Boom. Kroc spent the next 25 years selling Lily paper cups and later milkshake machines to the food service industry. He never ran a restaurant, never served a hamburger and never sold a milkshake, but he knew the convenience foods and the food service industry intimately.

An early example of his initiative and vision involved the Walgreen Drug Company. Kroc reasoned that the new Lily paper cups could be used at Walgreens to sell malts and soft drinks "to go" to overflow crowds. Walgreen headquarters was near a company drug store just down the street in downtown Chicago. The Walgreen's manager rejected Kroc's advice, "You're crazy or else you think I am" he protested, "I get the same fifteen cents for a malt if its drunk at the counter, so why the hell should I pay a cent and a half for your cup and earn less?" Kroc replied, "You would increase your volume. You could have a special area at the counter where you would sell those things, put covers on them and take them and the same vanilla wafers to serve with them and drop them in a bag to take out."[1] The manager rejected his plea. Kroc offered to give him 300 containers with covers if he would just try the experiment. The manager finally agreed and Kroc delivered 300 containers of Lily paper cups. Thus began the takeout service at Walgreen's soda fountains in downtown Chicago which greatly expanded the sale of Lily cups and was a precursor to Dairy Queen and other ice cream and fast food restaurants.

Continuing in the food service business after World War II, Kroc was selling milkshake multi-mixers to national accounts when he heard about a successful hamburger restaurant in California where the McDonald's Brothers restaurant used six multi-mixer milkshake machines, which was three times any other restaurant that Kroc served. After visiting the San Bernardino store, Kroc became convinced he could sell mixers to every new franchise restaurant that they opened. He offered his services to the McDonald's Brothers who were looking for a new franchising agent.

II. THE MCDONALD'S RESTAURANT – AN EXISTING PATTERN OF BEHAVIOR IS MODIFIED

Mac McDonald and his brother, Dick, operated a typical San Bernardino restaurant. The drive-in had terrific business, especially among teenagers. After World War II, the brothers realized they were running hard just to stay in place and competing against all similar drive-in restaurants in Southern California. They closed the restaurant in 1948 and reopened later that year with a radically different kind of operation. It was a restaurant stripped down to the minimum in service and menu items. The prototype McDonald's served as a model for legions of fast food

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[1]Kroc, Ray, *Grinding it Out – The Making of McDonald's*.

units that would later spread across the land. Hamburgers, fries and beverages were prepared on an assembly line basis. Mac and Dick succeeded beyond their wildest dreams. The simplicity of the procedure allowed McDonald's to concentrate on quality in every step and that was the trick. When Ray Kroc visited the McDonald's restaurant in 1954, the brothers had already given a license to ten other drive-in restaurants in California and two in Arizona. They were thinking about franchising, but didn't want to spend the time on the project and needed someone to help. Ray Kroc volunteered. McDonald's lawyer drew up a straightforward, simple agreement which maintained control for the restaurant format and building design with the McDonald's brothers. The agreement gave Kroc a 1.9% fee of the gross sales from the franchisees. Of the 1.9%, however, the brothers got .5%, so Kroc's net fee was 1.4% of the gross sales, plus a $950.00 franchise fee for each license sold. The contract was for ten years. Later, it was amended to 99 years.

III. McDONALD'S SERVICES, INC. - THE FRANCHISE PATTERN

Kroc returned to Oak Brook, Illinois, and immediately devoted his full attention to the franchise enterprise. Ray Kroc set the policy for the McDonald's franchise operation. Kroc's personal commitment to quality, service and cleanliness is legendary. QSC long ago became the most popular acronym among fast food operators, but the phrase originated with Kroc. He used QSC to distinguish McDonald's from all other competitors in an industry that was full of copycats. "Remember, the McDonald brothers had not given him a secret recipe for hamburgers, milkshakes and french fries." "He possessed no patents, no technological breakthrough and no new product." "Kroc was not handed a Xerox or a Polaroid."[2] The key to McDonald's franchise operation was

[2] Love, John, *McDonald's: Behind the Arches*.

a uniform operating system where QSC really was the guiding principle. McDonald's franchisees were counted on to deliver the same quality of food and service time after time.

One of the keys to this development of uniformity was Kroc's business method for expanding the franchise enterprise. Unlike manufacturers which produce uniform products simply by centralizing production, fast food franchisors sell a product produced locally by infinitely different operators. Kroc's insight was to form a partnership with his franchisees one restaurant at a time. McDonald's did not grant territories to its franchisees. Rather, the restaurants were selected one at a time for each franchise. A franchisee could expand his operation and earn more restaurant sites by steady performance and fealty to the McDonald's operating methods. One famous restauranteur switched from Coke to Pepsi and he was never granted another franchise. Some of the original franchisees were golf buddies of Kroc from his Oak Brook, Illinois, country club. Although they ran acceptable restaurants, they were not hands-on operators. He learned that passive investors were simply unsuitable franchisees because they would not have the hands-on devotion to QSC. As one critic put it, "McDonald's franchisees bleed ketchup."

Another example of this franchise culture is Oak Brook, Illinois. In 1971, McDonald's moved to its corporate headquarters to Oak Brook, Illinois, a white collar suburb west of Chicago. It was in the middle of a six suburb market that had only one McDonald's restaurant. It was a vastly underdeveloped market. The reason Joseph Sweeney had gotten a franchise was a deal he made with Kroc in 1957. His one store in Oak Brook did not live up to McDonald's tough standards. Sweeney never got a license for a second store in the Chicago suburbs. The company bought back his franchise in 1968 and the old territory quickly expanded to fifteen McDonald's restaurants after 1971.

A second strategic decision, uncommon in franchise operations, was that Kroc resisted the temptation to make big profits by selling products and equipment to his franchisors. You can imagine that each McDonald's restaurant franchisee had to purchase kitchen equipment, utensils and, of course, food product. Virtually all other major fast food franchisors made a good portion of their profits on the markup on goods they supplied to their operators. Dairy Queen took 45¢ out of every $1.40 gallon of mix its approved dairies sold to the operators. General Equipment Co. provided shake machines, broilers and most other kitchen equipment to Burger Chef franchisees. Chicken Delight required its franchisees to purchase chicken coolers. Howard Johnson built ice cream and candy plants to supply franchisees and operated huge commissaries. Burger King's DavMor Industries manufactured broilers to be sold to its franchisees and operated commissaries. In sharp contrast, Kroc sold his franchisees just $150.00 multi-mixers and that was only during the first decade. Kroc believed that selling products to franchisees can create the appearance – real or imagined – of a conflict of interest between the franchisor and the franchisee. A second negative effect from supplying franchisees product and equipment was that the franchisors tended to pay more attention to the commissaries and manufacturing plants rather than the stores. By contrast, gross sales at the store meant everything to McDonald's. It made most of its money initially on the 1.9% franchise store fees. This encouraged the development of the franchise model and was a significant competitive advantage for McDonald's compared to other restaurant franchise operations in the 50's and 60's.

Another Kroc insight into developing the McDonald's culture and successful entrepreneurial plan was his selection of suppliers for the restaurants. Many franchisors received percentage fees or kickbacks which inflated the charges suppliers offered to franchisees. So called rebates from fast food vendors were never accepted by Kroc. Kroc also tended to select small companies rather than major national companies. By having small suppliers, they essentially became part of the franchise culture because their business devotion to McDonald's methods assured them a steady, growing order of products. For example, Harry Smargon founded a tiny shortening company in Chicago in 1952. He began getting orders over the phone from Kroc who had heard that Smargon shortening was superior to other vendors. Kroc had only three stores in the Chicago area, but 500 pounds for each store was a big order for Smargon. Smargon's company, Interstate Foods, eventually became the largest supplier of shortening in the fast food business, with revenues exceeding $100 million a year. Smargon says, "McDonald's showed suppliers and franchisees alike that it was in the business for the long haul not the short haul"[3] by not indulging in kickbacks.

In essence, Kroc's simple franchising philosophy was that "a franchising company should not live off the sweat of its franchisees but should succeed by helping its franchisees succeed." [4]

IV. THE OWNER / OPERATOR – REPEATING MCDONALD'S CULTURE

Once Kroc had his agreement with the McDonald brothers to franchise the McDonald's restaurants, Kroc needed to develop the franchise system immediately. It was tough going at first. He opened his own store in Des Plaines, Illinois, and enjoyed success, but there were few prospects in the Chicago area at first.

I will share two typical owner/operator stories with you. In 1955, Sandy Agate was a 46 year old Chicago pressman who dreamed of running his own small business. In late 1955, the Agates paid Kroc the $950.00 franchising fee and McDonald's Real Estate Vice President Harry Sonneborn told Agates about a property for rent in Waukegon, 50 miles north of Chicago. The

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[3]Love, John, *McDonald's: Behind the Arches*.

[4]Love, John, *McDonalds: Behind the Arches*.

Agates liked Waukegon because it was "a lunch pail town." The predominantly blue collar workers were the very type of clientele who would frequent McDonald's restaurants. There was only one hamburger stand in the whole town of 60,000 people. Kroc persuaded a local banker to build a McDonald's restaurant on a vacant lot and rent it to the Agates, charging them 5% of their sales, but no more than $1,000 per month and no less than $500 per month. Agates didn't have enough money to build a McDonald's store on their own, but they agreed to sign the lease. The banker, of course, never dreamed that the tiny hamburger store would exceed monthly sales of $20,000, the point at which the percentage rent would hit the $1,000 cap. Ironically, it reached that figure in the first month. Agate quit his printing job to take up the hamburger spatula and his wife worked behind the counter. They were the first of hundreds of husband and wife teams to operate a McDonald's. The security deposit on the lease, the license fee, payments for the sign and equipment consumed their $25,000 life savings. Two days before the opening, Kroc reminded Agate that he would need $100 cash to make change when he opened the restaurant. Agate blew up. "You haven't been telling me the whole truth," he shouted. "I'd never have gone into this business if I had known all the things I would have to do." Kroc's response was, "That's why I didn't tell you."[5] Agate tapped the family's last cash reserve of $150. He put $100 in the cash register and gave the rest to his wife for household expenses. On the first day Sandy Agate's McDonald's opened, customers lined up down the street. The driver for Mary Ann Baking in Chicago, McDonald's first bun supplier, warned Agate that he had over ordered by requesting 125 dozen buns. "You will be throwing them at each other when the day is over." By 5 o'clock that afternoon, the store was running out of buns and Agate placed an emergency order. On his first day, Agate grossed $450. The next day, Friday, was supposed to be a bad day for hamburger

[5]Love, John, *McDonald's: Behind the Arches*.

sales in the predominately Catholic town of Waukegon. Sales hit $800. The two cash registers were too small and by the end of the day they were stuffed with currency. Agate took the money home in brown paper bags because he didn't have deposit bags from his local bank. Saturday morning, in a steady rain, customers began lining up a 10 o'clock, a full hour before opening. Agate's store had a $1,000 day. "At 5 o'clock Sunday, Agate ran out of meat. When Agate told his customers standing in line there would be a half hour delay, he was aghast at their response – virtually everyone waited."[6] All of this through local word of mouth. Agate's McDonald's blockbuster success was the lynchpin that propelled the McDonald's enterprise. Copies of Agate's financial statements were printed and distributed to McDonald's prospects. Agate noticed cars with out-of-state license plates in his parking lot. The cars were owned by prospects Kroc had sent out to inspect the store.

My second story involves local McDonald's owner/operator, Rick Reichenbach. Rick started working for McDonald's earning $1.40 an hour during high school and summers when he was home from college. He graduated from college in 1975 in the midst of the recession. Jobs were tough. His mother encouraged him to work at the McDonald's company store. He became a management trainee. He served as the McDonald's manager and later regional director in the Baltimore market for many years. By 1996, he entered into a joint partnership agreement with McDonald's. He currently has five stores in the Bluffton - Marion area. His son, Ross, a Canterbury High School graduate, is currently in the McDonald's "Second Generation Program" as a trainee and intern. The Reichenbach family plans for Ross to come back to Fort Wayne to become a co-owner with Rick in the stores. This is something that McDonald's encourages for successful franchisees.

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[6]Love, John, *McDonald's: Behind the Arches*.

Rick confirmed that there are currently 34,000 McDonald's stores worldwide. In the U.S., there are approximately 15,000 stores and about 15% are owned by the company. Reichenbach confirms Ray Kroc's account that owner/operators actually created many McDonald's successful menu items. For example, Louis Groen had McDonald's restaurants in Cincinnati, Ohio. He was doing well, but Friday was a terrible day because the Roman Catholic population would not eat meat. Every Friday, Big Boy's restaurants dominated the fast food business because they had a fish sandwich. Kroc did not want Lou to have a fish sandwich at his McDonald's restaurants. Groen persisted and eventually it was agreed that McDonald's would have a North Atlantic white fish sandwich. In the McDonald's test kitchen, a young crew member put a piece of cheese on a fish sandwich and the rest is history. They had their answer. The white fish sandwich with a slice of cheese became McDonald's Filet-o-Fish. They started selling it on Fridays in limited areas, but by 1965 it was available every day. Kroc acknowledges in his autobiography that the Big Mac, the Hot Apple Pie and the Egg McMuffin all evolved from ideas suggested by franchisees. Indeed, Reichenbach tells me that the Sausage Biscuit was created by some crew people at a McDonald's restaurant who would take the leftover sausage patties and biscuits from the Big Breakfast and create their own snacks. McDonald's soon adopted the Sausage Biscuits for the breakfast menu.

Another interesting story Rick told me involves the sale of coffee. My Aunt Marilyn Osborn drove to the McDonald's restaurant in Marion for McDonald's coffee and breakfast every day for many years. She loved the original McDonald's coffee. I was never a fan! Nonetheless, with the advent of competition from Starbucks and Dunkin' Donuts, McDonald's was searching for a premium coffee blend to stem the competition. Rick tells me that McDonald's purchased expensive new coffee grinding and coffee making machines and it was prepared to introduce the premium coffee with a massive marketing campaign several years ago. "Someone at corporate decided to postpone the marketing campaign." The operators already had the machines and the coffee, so the coffee was sold without fanfare. They just didn't market it. Almost a year passed before the premium coffee marketing campaign was unveiled. In the first week, many customers would compliment the store managers on how good the new premium coffee was. This was amazing because they had already been drinking the same coffee for months. Hence, the power of McDonald's marketing.

Another example of McDonald's and its owner/operator's fierce competitive streak is the adoption of the smoothies and lattes. The complexity of the smoothies and lattes was another challenge because the menu had become so complex. Nonetheless, they decided to sell it and sell it faster than Starbucks according to Rick Reichenbach. Smoothies and lattes are now a major profit center for McDonald's. It is believed these menu choices have succeeded in maintaining the loyalty of many McDonald's customers who would otherwise frequent Starbucks and Dunkin' Donuts.

Rick told me that the "average" McDonald's restaurant is a $2.5 million investment. He reported that the typical McDonald's restaurant derives 70% of its gross sales from the drive-thru business.

V. THE MCDONALD'S EMPIRE – THE BUSINESS ENDURES ACROSS GENERATIONS

By 1957, Ray Kroc had assembled all of the elements he needed to make his McDonald's franchise system successful. The owner/operators had an opportunity to get a business on their own without having to pay excessive franchising charges or to make unfair purchasing commitments. The franchisees' success was attracting attention from prospective franchisees and the restaurant business was expanding quickly. McDonald's highly disciplined operations system was ensuring a higher standard of quality, service and cleanliness far superior to other drive-in restaurant competitors. Most of the McDonald's Services, Inc. income was coming from the 1.9% service fee. There were no up front fees for territorial licenses. Kroc made no money on supplying McDonald's operators with food and equipment. Indeed, everyone was making money on McDonald's except Ray Kroc's company. His stores were averaging $200,000 in annual sales in the late 1950's, but of that McDonald's got a $2,800 retainable service fee. The average franchisee was making an operating profit of about $40,000 per year. What made McDonald's into a money machine had nothing to do with Ray Kroc's vision of QSC, or the McDonalds brothers or even the popularity of McDonald's hamburgers, french fries and milkshakes. "Rather, McDonald's made its money on real estate and on a little known formula developed by Henry Sonneborn."[7] Sonneborn served as McDonald's Chief Financial Officer during its first decade. He developed a novel way for the corporation to make money that did not conflict with Kroc's concept of fairness to suppliers and franchisees. Sonneborn conceived of the idea of making money on real estate that McDonald's would lease to its franchisees. McDonald's formed a separate real estate company – Franchise Realty Corporation – which would locate and lease restaurant sites from landowners wanting to build McDonald's units, which would then be leased to the company. Franchise Realty would enter into a 20-year lease with the property owners and then sublease the store to the franchisee charging a markup for the real estate services it was providing. Better yet, McDonald's lease from the property owner was a fixed rent, but the sublease to the franchisees was a variable rent with a percentage of sales. The net effect was that McDonald's real estate costs were fixed for 20 years with the property owner and all of the

[7]Love, John, *McDonald's: Behind the Arches*.

subleases were net net leases, meaning the franchisees were responsible for all property insurance and taxes and McDonald's rental income increased as the stores' operating revenues grew. Franchise Realty produced immediate cash flow and provided money which allowed the McDonald's Corporation to quickly expand with new locations, do product research and lead to the phenomenal growth of the company.

McDonald's chose to make its money primarily on real estate leases with its franchisees. Many other franchise businesses – not just fast food – make their money on fees and products sold to franchisees. The courts have been critical of many excessive franchise fees and other charges. Real estate leases have substantial legal precedents in all states and are typically upheld as legitimate business contracts. Hence, McDonald's has earned its share of the franchisee's profits through real estate percentage rent as compared to excessive franchise fees or other charges. "In 1982, the net book value of McDonald's property and equipment exceeded for the first time all of Sears & Roebuck properties, making McDonald's the owner of the most valuable retail real estate in the world." "The real economic value of McDonald's real estate is in the rental income it produces." "McDonald's earns about 39% of its net income from the 29% of the non-franchised units that it owns and operates, but the rest of its income comes from franchise restaurants."[8] And about 90% of that profit comes from its real estate operations.

The McDonald's culture has now expanded to 119 countries and territories around the world. McDonald's restaurants serve 68 million customers each day. With 34,000 restaurants worldwide, it employs more than 1.7 million people. McDonald's has increased shareholder dividends for 25 consecutive years. In October 2012, its monthly sales fell for the first time in 9 years.

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[8]Love, John, *McDonald's: Behind the Arches*.

VI. <u>McDonald's Culture – Quality, Service and Cleanliness</u>

In conclusion, Ray Kroc was a visionary salesman and leader of the McDonald's franchise system. He died January 14, 1984, at age 81. His QSC mantra became a corporate culture of entrepreneurialship, innovation, competition and changed American and even world culture in many ways. Even the finest luxury cars now host cup holders for takeout beverages. If 70% of McDonald's sales are at the drive-thru window, that tells you that a lot of soccer moms, travelers, commuters and families prefer the convenience of food and beverages on the go. In Eric Schlosser's book "Fast Food Nation," the author criticized McDonald's advertising techniques which target children. He is correct. McDonald's is the world's largest distributor of toys, which it includes with kids' meals. Many people contend the use of this marketing strategy encourages children to eat more McDonald's food, of course, thereby contributing to another generation's devotion to takeout meals. The McDonald's culture is thereby passed onto the next generation.

Nonetheless, McDonald's has been responsive to the apt criticism and changing consumer tastes with the expanded menu to include salads, fish, wraps, smoothies and fruit. Six weeks after the 2004 documentary film "Super Size Me," which contended McDonald's food was contributing to the epidemic of obesity in society, and that the company failed to provide nutritional information about its food for its customers, McDonald's announced it was eliminating the Super Size option and created the "Adult Happy Meal." Today, the McDonald's Extra Value Meals are imitated throughout the industry. These "Value Meals" again encourage customers to upgrade the size of french fries and soft drinks for increased sales and profits for the restaurant. No one makes us buy the large or extra large size, but many consumers choose to do so. Ultimately, consumers – yes, us – choose what meals we will purchase.

Last Thursday, I purchased small french fries, a cheeseburger and a small vanilla shake at the downtown McDonald's for $3.84. Cheeseburger - 300 calories and 12 grams of fat; Fries - 230 calories and 15 grams total fat; and Shake - 530 calories and 17 grams of total fat.

There is no doubt, however, that most Americans and consumers around the world will continue to choose McDonald's meals because Ray Kroc had a unique vision – Quality, Service and Cleanliness – which encouraged his franchisees to innovate and provide consistent, reasonably priced food for its customers. The McDonald's culture is here to stay. Hopefully, the cultural trends will continue to evolve to a more nutritious and lean "Happy Meal" – NO MORE SUPER SIZE!

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JOAN B. KROC CHARITABLE BEQUESTS

Joan Kroc, the third wife of Ray Kroc, died of brain cancer October 12, 2003, at the age of 75. Her Will included significant bequests for these organizations:

1. $1.6 billion for the Salvation Army;

2. $225 million for National Public Radio;

3. $50 million for the University of San Diego's Joan B. Kroc Institute for Peace and Justice;

4. $50 million for the University of Notre Dame's Joan B. Kroc Institute for International Peace Studies;

5. $20 million for the San Diego Hospice and Palliative Care Institute;

6. $10 million for the Zoological Society of San Diego which runs the San Diego Zoo and the San Diego Safari Park; and

7. $5 million for San Diego's KPBS Public Radio and Television Stations.